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CORRESPONDENCE

Extensions of Auditing Procedure

Editor, THE JOURNAL OF ACCOUNTANCY:

DEAR SIR: Now that the special committee on auditing procedure has completed its immediate job and has recommended certain extensions of auditing procedure, in respect to the items of inventories and receivables, which have been adopted by the American Institute of Accountants, I desire to comment upon the letter of Earle Goodrich Lee published in the September, 1939, issue of THE JOURNAL OF ACCOUNTANCY, pages 194–196, where I received the first intimation of it.

To find that any member of the Institute, after the long training and experience necessary to qualify him for that membership, should so completely misconstrue and misinterpret the report of the special committee on auditing procedure or the statements made in my paper published in the August issue of THE JOURNAL OF ACCOUNTANCY is both surprising and disappointing. Unless I misread Mr. Lee's letter, he seems to have the idea that the committee recommends the acceptance by the accountant of the amounts he finds on the financial statements of a company when he arrives to perform the audit, without demanding that there be made therein all adjustments and entries which, as a result of his examination, he finds necessary in order that the statements shall as truly as possible represent the facts they purport to display. It seems difficult to believe that an intelligent accountant studying the report could ever draw such a conclusion.

The fact that the financial statements, including footnotes and supplementary data, are the representations of the client is not only well understood, but is even demanded by the Securities and Exchange Commission, by the various national exchanges upon which securities of the client may be listed, by the states' securities commissions, and by other bodies who demand that the client place his signature thereon as proof that they are his representations as to his financial affairs.

They further demand that they shall be made sufficiently complete and clear, thereby frequently requiring footnotes and other explanatory data. In the wording of these footnotes or in determining what notes or explanatory data are necessary, both the accountant and the attorney serve as advisors to the client and if the client accepts such footnotes or data they then become part of his representations to the public and are embodied in the subject matter to which his signature applies.

Mr. Lee's assumptions that any reputable accountant "takes the position that he is not under obligation to disclose internal irregularities" or that "he absolutely ignores the possibility of any unrecorded liabilities or other adjustments" are, of course, entirely unwarranted. It is regrettable that he should have allowed his name to be used in print in connection with any such implausible assumptions. I suggest to him that he read the American Institute of Accountants' pamphlet, *Examination of Financial Statements*, which gives in great detail the work of the accountant which precedes the use of his report or certificate in connection with financial statements, as the report of the Institute's special committee and my paper in connection therewith were concerned with broad principles and did not repeat all of the details, and they were intended for an audience presumed to be already thoroughly familiar with these details.

As to the short form of report suggested by the committee, Mr. Lee does not need to use it unless he desires to do so. The Institute has never *required* any particular form of report or certificate to be used by its members over their signatures.

Yours truly,

P. W. R. GLOVER

New York, N. Y.

Unamortized Discount and Premium on Bonds Refunded

Editor, THE JOURNAL OF ACCOUNTANCY:

DEAR SIR: I have read with considerable interest the bulletin dealing with "Unamortized Discount and Redemption Premium on Bonds Refunded," which has been issued as the second accounting research bulletin of the Institute's committee on accounting procedure.

The questions dealt with in the bulletin are probably of greater interest to companies engaged in the utility industry than to any other group. As indicated in the bulletin, the various regulatory bodies which have jurisdiction over the accounts of public utilities vary in their approach to the questions involved.

At the same time, these bodies undoubtedly are influenced in their decisions by principles enunciated by an important committee of the American Institute of Accountants and opinions expressed by the committee, therefore, might easily tend to become binding upon utility companies operating in many states even before those opinions had become thoroughly crystallized in general accounting practice. For this reason, it appears to be important that there be further discussion of certain of the points raised in the bulletin.

The bulletin clearly sets forth the desirability of recognizing the principle that unamortized discount and redemption premium on bonds refunded should be amortized over some period subsequent to the date of the refunding and not necessarily charged to surplus at that date. The recognition of this principle is fairly widespread. Even in California, in which state four of the five public-utility commission decisions referred to in Appendix A to the bulletin originate, the commission has permitted variations from the requirement of their system of accounts that such items be charged to surplus. Of the four cases cited, the California commission in two decisions (the Monrovia Telephone and Southern California Edison cases) required the premium on redemption to be charged to surplus. In the California Water Service case, the commission said that discount and premium should, under the California system of accounts, be charged to surplus, but gave permission for it to be amortized over the life of the old issue. In the Pacific Gas and Electric Company case, decided in 1935, the commission permitted the company to amortize the unamortized discount and the premium on the bonds retired over the life of the new bonds, stating, however, "We have considered this part of applicant's request and believe that if it is considered purely as a matter of accounting convenience, it may be granted. However, such orders of the commission relating to the manner in which accounting entries may be made should not be taken as depriving the commission of the power to withdraw its permit at any time or as binding it to the acceptance of such accounting entries if involved in other proceedings." Thus the California commission has, in the four cases quoted, permitted three different methods of dealing with this matter. Cases can be cited in other states in which one or other of the three methods has been permitted, and it has so far seemed unlikely that a hard and fast rule would be adopted by regulatory bodies generally, requiring one of these alternative procedures to be followed to the exclusion of the others.

As to the period subsequent to the date of the refunding over which the unamortized discount and premium on bonds refunded should be amortized, however, there is still room for difference of opinion. The bulletin arrives at the conclusion that "their immediate writing off or amortization over the term of the old issue must today be regarded as acceptable accounting practice. . . . In the committee's opinion, however, exception should be taken to spreading the item over the life of the new bonds. . . ." As to this last exception, the bulletin indicates that the practice should be accepted where authorized by a regulatory body or adopted prior to the publication of the bulletin.

It is to this conclusion, which is in effect a pronouncement against the validity of amortizing the item in question over the life of the new bonds, that I wish to take exception. I think it can readily be demonstrated: first, that amortization over the life of the new bonds conforms to the procedure which must necessarily be followed in determining whether and to what extent refunding is advantageous under a given set of conditions; and second, that it is entirely logical in determining the effective cost of money to the company.

I recognize that the first of these two statements is at variance with that made by the committee in the first full paragraph on page 14 of the bulletin. There, referring to the hypothetical case of an issue of 25-year bonds, ten years of the life of which have expired, it is stated, "Thus, in the hypothetical case assumed, in order to determine what interest rate would make refunding advantageous, we have to ascertain the effective yield of a 5 per cent bond with fifteen years to run, bought at the redemption price of 105. Since we find this to be 4.54 per cent, the refunding will be advantageous if and to the extent that it can be effected at a rate lower than 4.54 per cent."

Let us consider this with respect to bonds with the same characteristics, but which mature over shorter periods. The literal meaning of the statement is that a 5 per cent bond, redeemable at 105 and maturing in one year, could not advantageously be refunded except at a slightly negative rate of interest; if it matured in two years, it would have to be refunded on a basis lower than 2.425 per cent; in three years, on a basis lower than 3.24 per cent; in five years, on a basis lower than 3.89 per cent. Actually, however, in any of these cases, a refunding by the sale of a 30-year 4 per cent bond at par would be advantageous.

It will simplify the discussion somewhat if the consideration of unamortized discount is disregarded for the moment and the matter looked at solely from the point of view of the premium on retirement of the old bonds. Let it be assumed that the old bonds were sold at par. They are now to be retired at a premium of 5 per cent and refunded by the issue of new bonds. The practical effect of this is that the proceeds of each $100 of the old bonds represent the *effective* proceeds of each $105 of the new bonds. Assuming again that the new bonds are sold at par, the effective sale price of the new bond is thus 95.24 per cent (i.e., $\frac{100}{105}$). The money cost of a 30-year 4 per cent bond sold on this basis is 4.28 per cent, and this obviously represents an advantageous refunding whether the old bonds had five years or fifteen years to run.

The test suggested in the bulletin of the advantage of refinancing, namely, the determination of the effective yield of the old bond for its unexpired term, purchased at its redemption price, is in my opinion applicable only to the consideration of the advantage of retiring the old bond by the application of other funds for which there is an alternative use. It is not in my opinion a correct test to apply to the question of refunding.

The bulletin points out that theoretically the treatment of the premium on redemption of the old bond and of the unamortized discount on that bond may properly be treated on the same basis and it may, therefore, be appropriate to extend the argument at this point to cover the question of unamortized discount. The refunding operation does, in fact, represent the issuance of a face amount of bonds the net proceeds of which are equivalent to the amount payable on redemption of the old bonds, against an amount of capital already secured by the company equivalent to the net proceeds received by the company on the sale of the old bonds adjusted by the amount of amortization of the discount on the old bonds. Thus, introducing the factor of unamortized discount, it may be said that the effective price of the new bonds is $\frac{A \times P}{100R}$ where A represents the price to the company on the sale of the old bonds, adjusted by the amortization of the discount, R represents the redemption price of the old bond and P represents the price to the company on the sale of the new bond. Incidentally, it is, of course, obvious that the unamortized discount and premium on the old bond are automatically spread over the life of the new bond if the coupon rate on the new bond is high enough to justify the sale of that bond at a premium sufficient to offset these factors.

I realize, however, that there has recently been a tendency to set discounts and premiums in compartments and to deal with them upon a statistical rather than a realistic financial basis, so that the practical solution which I have suggested may not be available as an argument.

It appears to me that the period over which the cost of refinancing should be spread can be limited to the unexpired term of the old bonds only by a misconception as to the nature of the transaction involved in the issuance of the new bonds. The refunding is carried through not merely for the purpose of reducing the money cost during the period represented by the unexpired term of the old

bonds. If that were the purpose, the maturity of the new bond issue would be made to coincide with the maturity of the old issue, because the shorter maturity would undoubtedly enable the company to refinance on a more favorable basis than that realized upon the sale of the longer-term issue. The fact is that the refinancing is undertaken because at that particular time the company is able to finance itself for the full term of the new bonds on a basis which appears to be advantageous—sufficiently advantageous, in fact, for the management to believe that it is more desirable to sell a long-term issue than to take the hazard of having to go into the market again after a shorter interval. It is this entire benefit against which the cost of retiring the old issue has to be applied. The benefit is not one which can be measured solely by the difference between one definitely ascertained money cost and another. It is a benefit which must be expressed in terms of the security enjoyed by the company in having its financing arranged for an extended term of years at a satisfactory money cost, incidental to which there is an ascertained saving through the reduction in money cost over the unexpired term of the old issue. To argue that this ascertained saving alone must absorb the cost to the company of the much greater advantage involved in the refinancing is looking at only one factor in the problem. Further, in ignoring the other factors, the period represented by the unexpired term of the old bonds is doubly penalized; first, in that it has to bear the heavier money cost resulting from the extended term of the refunding issue as compared with what the money cost would have been for an issue limited to the unexpired term of the old bonds and, second, because on top of this it has to bear the entire cost of the benefit to the company for the full term of the new issue which certainly must be in contemplation when the decision to make a long-term refunding issue is arrived at. The restriction of the amortization of the premium to the period represented by the unexpired term of the old bonds is thus shown to be inequitable and it is difficult to see why it should be regarded as logical, or that it is supported by the examples given in Appendix C.

I should like to suggest that reference at one or two points in the bulletin to the retirement of the old bonds as "terminating an agreement which has become disadvantageous" puts the emphasis in the wrong place. The situation is rather that a more advantageous agreement can be made, but only at a cost, stipulated in the original agreement, which must necessarily be incurred to make it possible for the company to enter into the new agreement. The two agreements cannot operate simultaneously, and it appears to be much more logical to hold that a part of the cost to the company of the new agreement consists of the premium paid for the retirement of the old bonds, than to hold that this premium is related in any way to the cost of money during the life of the old agreement. If the old bonds had run to maturity, the premium would not have been incurred. How then can the unexpired term of the old bonds be used as a factor in determining the period over which the premium should be amortized?

I have deliberately stressed the argument as applied to the premium on retirement of the old bonds. Theoretically, and on the basis of historical cost of money, I think I have shown that unamortized discount on the old bonds should also be spread over the life of the new issue. On the face of it, however, it appears to be more conservative, and perhaps to be logical, to amortize this item over the unexpired term of the old bonds with respect to which it was originally incurred. However, in the further discussion of this whole subject, for which I hope there will be an opportunity, I should like to suggest that the amortization of unamortized discount over the life of the new bonds should also be considered as an acceptable alternative.

One possible factor in the situation which the committee may have had in mind as representing a danger in amortizing premium on retirement over the life of the new issue is the "pyramiding" effect of a succession of refundings. To avoid burdening this letter with detail, I am omitting any discussion of this point. If, however, it appears desirable that this aspect of the matter be gone into, I shall be glad to endeavor to show by means of hypothetical examples that it is hardly conceivable that this danger can really become a serious one.

Yours truly,

HERBERT C. FREEMAN

New York, N. Y.

Mutual Stockholdings in Consolidated Statements

Editor, THE JOURNAL OF ACCOUNTANCY:

DEAR SIR: In an article under this heading in the October issue of THE JOURNAL OF ACCOUNTANCY, Mr. Maurice Moonitz criticizes the customary method of computing minority interests for consolidated statements if there are mutual holdings of capital stock. This customary method consists in the use of simultaneous equations to arrive at the true net worth of the subsidiary or subsidiaries, and the computation of minority interests on the basis of the true net worth, thus found.

Mr. Moonitz bases his argumentation against this procedure upon the similarity which stock of the parent company held by the subsidiary bears to treasury stock. He cites cases where the courts were inclined to ignore the fiction that corporations are persons separate and distinct from their owners, and implies that, in disregard of this fiction, stocks of a corporation held by its subsidiary should be treated as treasury stock, and be deprived of their voting power and their right to share in dividends. Mr. Moonitz then presents a way of computing minority interests which is based on the assumption that shares of the parent company held by the subsidiary and an equivalent amount of stock of the subsidiary held by the parent corporation do not share in dividends.

Actually, under present law, all outstanding shares of a corporation's stock, including those in the hands of subsidiaries are entitled to dividends, and share in profits and losses that may arise in final liquidation. The customary way of computing minority interests by means of simultaneous equations takes full cognizance of this fact, and therefore represents the correct method in the preparation of consolidated statements.

The fiction of a corporation as a person separate and distinct from its owners has been created by law, and will be upheld by law unless it is misused. While the voting power of stocks mutually held by parent and subsidiary company may be misused, it is hard to see how this can happen to the right to receive dividends. It is therefore highly unlikely that the courts will ever deprive the subsidiary of its right to receive dividends on stock of the parent company, especially so since it would be extremely difficult to compensate the minority holders properly for the resulting loss in income. Mr. Moonitz's suggestion that an equivalent amount of stock of the subsidiary held by the parent company would have to forego its right to dividends faces the question: what is an equivalent amount? The answer presented in Mr. Moonitz's example on page 235 would be unfair to the minority interests if their shares were worth less than book value, but would favor them unduly if the market value of their stocks or their capitalized earning power were in excess of the book value. Fortunately, we do not have to bother about this question, nor about an exact definition of the term "shares mutually held." For the problem how consolidated statements would look if "shares mutually held" were deprived of their right to dividends is entirely fictitious.

Yours truly,

HAROLD S. BENJAMIN

New York, N. Y.

Editor, THE JOURNAL OF ACCOUNTANCY:

DEAR SIR: I should like to comment upon Mr. Maurice Moonitz's suggested solution to the problem of consolidating statements of companies which have mutual stock investments as presented in his article "Mutual Stockholdings in Consolidated Statements" in the October number of THE JOURNAL.

Mr. Moonitz seems to have confused the issue of determining the actual control of the interrelated companies and that of allocating the earnings of the companies among outside shareholders. This is indicated by his statement that "It might very well be in some instances that the extra-group stockholders would be thrown into the position of the dominant group through the elimination of mutual holdings as treasury stock" after his example to show the difference in net worth allocated to the extra-group interest when computed according to his proposed method from that computed by the conventional method.

I believe that it is quite generally recognized that the corporate fiction should not be carried so far as to permit a group of mutually controlled corporations to be directed by a self-perpetuating management without regard to the real equity owners, the outside stockholders. It is for the protection of such real equity owners against injustice and fraud that courts have set aside this

corporate fiction, as in the cases quoted by Mr. Moonitz.

For determining the division of earnings and net worth, however, it would seem that the proposed method overlooks the fact that although the statements of the companies may be consolidated, the minority interest in the subsidiary company is interested primarily in the subsidiary company by itself. To these minority stockholders an investment in a parent company is an investment of a part of their company's net worth and could not equitably, in most cases, be eliminated merely because the parent company had as large, or larger, an investment in their company. The stock held by the parent, from their point of view, could not be considered as treasury stock in the calculation of their net worth. In the case of mutually owned majority interests, each group of outside stockholders is theoretically in the position of a minority group. Each is vitally interested in the other company and its investment could not be portrayed clearly by converting it to treasury stock, an investment in itself. This investment only theoretically represents treasury stock to the extent that it is supported in part by the asset of its own stock held by the other company.

The injustice of calculating the division of net worth by treating mutual investments as treasury stock may be seen by considering the rate of earnings upon net worth of the two companies. The investment by one company in the other may be to obtain a higher rate of earnings than may be obtained by investment elsewhere, to secure trade advantages, etc. In any case it would seem equitable that all the shareholders should receive the results of this investment, and according to the conventional allocation they would do so. Should the company in which they invest be earning at a higher rate than their own they obtain a share of these higher earnings. By treating the mutual investments as treasury stock, however, in this case they would only obtain their own company's lower rate of earnings on the money so invested. In the example given by Mr. Moonitz, by changing the computation of net worth from the basis of an investment of assets of Company B in the higher earning Company A to an investment in its own lower earning company, the minority interest is reduced $1,263.74. Considering the investment of the funds of this company as being upon the basis of obtaining the greatest benefit for all its shareholders, this proposed method of allocating net worth would seem to be inequitable.

For these reasons, although Mr. Moonitz's comments as to the treatment of mutual stockholdings in respect to determining actual control of the group and as to the misleading impression given by the separate statements of such companies are justified, his method of allocating the net worth would be inequitable to the outside shareholders and deprive them of the intended advantages or disadvantages which should naturally result from the investment of their funds.

Yours truly,

Edwin D. Alford

Los Angeles, Calif.